Unaudited Condensed Interim Consolidated Financial Statements of

ARSENAL ENERGY INC.

For the Three Months Ended March 31, 2012 and 2011

Arsenal Energy Inc.

Condensed Interim Consolidated Statements of Financial Position
(Unaudited)

(thousands)	March 31, 2012	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 703	$ 626
Accounts receivable	8,989	11,677
Inventory	504	482
Prepaid expenses and deposits	602	978
	10,798	13,763
Reclamation deposit	150	153
Exploration and evaluation assets (note 4)	10,111	9,100
Property, plant and equipment (note 5 and 6)	143,928	146,195
Deferred taxes	1,775	1,775
	$166,762	$170,986
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 14,342	$ 17,453
Risk management contracts (note 10)	3,836	2,291
	18,178	19,744
Bank loan (note 8)	53,162	52,062
Risk management contracts (note 10)	2,492	1,485
Decommissioning obligations (note 8)	36,615	37,326
Deferred taxes	6,656	5,496
	117,103	116,113
Shareholders' Equity:		
Common shares	135,988	136,860
Contributed surplus	10,542	9,987
Accumulated other comprehensive loss	(277)	(153)
Deficit	(96,594)	(91,821)
	49,659	54,873
	$166,762	$170,986

Segmented information (note 14)

Commitments and contingencies (note 15)

The notes are an integral part of these consolidated financial statements.

Arsenal Energy Inc.

Condensed Interim Consolidated Statements of Loss
(Unaudited)

(thousands, except per share amounts)	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Revenue		
Oil and gas	$ 21,199	$ 11,619
Royalties	(4,949)	(2,017)
	16,250	9,602
Realized loss on risk management contracts (note 10)	(782)	(271)
Unrealized loss on risk management contracts (note 10)	(2,552)	(2,941)
	12,916	6,390
Expenses		
Operating and transportation	7,178	3,081
General and administrative	946	1,060
Exploration and evaluation (note 4)	(122)	4,417
Property, plant and equipment impairment (note 6)	1,950	2,500
Depletion and depreciation (note 5)	5,958	2,788
Share-based compensation	279	292
Transaction costs	121	-
Gain on sale of property (note 5)	(870)	-
	15,440	14,138
Loss from operations	(2,524)	(7,748)
Financial items		
Interest and other financing charges (note 13)	528	127
Accretion (note 8 and13)	255	172
Foreign exchange loss	196	144
	979	443
Loss before income tax	(3,503)	(8,191)
Deferred tax expense (recovery)	1,270	(251)
Net loss for the period	$ (4,773)	$ (7,940)
Loss per share (note 9 (c))		
Basic and diluted	$ (0.03)	$ (0.05)

Condensed Interim Consolidated Statements of Comprehensive Loss

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Net loss for the period	$ (4,773)	$ (7,940)
Translation loss on foreign operations	(124)	(110)
Comprehensive loss	$ (4,897)	$ (8,050)

The notes are an integral part of these consolidated financial statements.

Arsenal Energy Inc.

Condensed Interim Consolidated Statements of Changes in Shareholders' Equity
(Unaudited)

(thousands)	Number of Shares	Share capital	Contributed surplus	Accumulated other comprehensive loss	Deficit	Total Shareholders' equity
Balance December 31, 2011	157,282	$136,860	$9,987	$(153)	$(91,821)	$54,873
Net loss for the period	-	-	-	-	(4,773)	(4,773)
Share-based compensation expensed	-	-	279	-	-	279
Share-based compensation capitalized	-	-	96	-	-	96
Transfer of share-based compensation on exercise of options (note 9 (a))	-	14	(14)	-	-	-
Issued on exercise of options (note 9 (a))	53	21	-	-	-	21
Repurchase of shares (note 9 (a))	(1,041)	(907)	194	-	-	(713)
Translation gain on foreign operations	-	-	-	(124)	-	(124)
Balance March 31, 2012	156,294	$135,988	$10,542	$(277)	$(96,594)	$49,659

(thousands)	Number of Shares	Share capital	Contributed surplus	Accumulated other comprehensive loss	Deficit	Total Shareholders' equity
Balance December 31, 2010	140,812	$122,609	$7,374	$(200)	$(89,276)	$40,507
Net loss for the period	-	-	-	-	(7,940)	(7,940)
Issue of shares (note 11 (a))	22,159	21,051	-	-	-	21,051
Share issue costs	-	(1,225)	-	-	-	(1,225)
Share-based compensation expensed	-	-	292	-	-	292
Share-based compensation capitalized	-	-	90	-	-	90
Transfer of share-based compensation on exercise of options	-	221	(221)	-	-	-
Issued on exercise of options	594	262	-	-	-	262
Repurchase of shares	(251)	(213)	7	-	-	(206)
Translation loss on foreign operations	-	-	-	(110)	-	(110)
Balance March 31, 2011	163,314	$142,705	$,7542	$(310)	$(97,216)	$52,721

The notes are an integral part of these consolidated financial statements.

Arsenal Energy Inc.

Condensed Interim Consolidated Statements of Cash Flows
(Unaudited)

(thousands)	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Operating Activities:		
Net loss for the period	$ (4,773)	$ (7,940)
Items not affecting cash:		
Unrealized loss on risk management contracts	2,552	2,941
Depletion and depreciation	5,958	2,788
Accretion	255	172
Transaction costs	121	-
Deferred tax expense (recovery)	1,270	(251)
Property, plant and equipment impairment	1,950	2,500
Share-based compensation	279	292
Unrealized foreign exchange (gain) loss	179	186
Gain on sale of property and equipment	(870)	-
Exploration and evaluation expense	(1)	3,686
Decommissioning obligations settled (note 8)	(12)	(106)
	6,908	4,268
Net change in non-cash working capital (note 12)	2,172	(1,466)
Net cash from operating activities	9,080	2,802
Financing Activities:		
Bank loan advances (repayments)	1,197	(10,971)
Issue of shares for cash	-	21,051
Issue of shares on exercise of stock options	21	262
Repurchase of shares	(713)	(206)
Share issue costs	-	(1,636)
Net change in non-cash working capital items (note 12)	57	77
Net cash from financing activities	562	8,577
Investing Activities:		
Property, plant and equipment	(6,361)	(7,284)
Exploration and evaluation expenditures	(1,011)	(4,867)
Transaction costs	(121)	-
Disposition of property, plant and equipment	33	473
Net change in non-cash working capital items (note 12)	(2,270)	1,595
Net cash (used in) investing activities	(9,730)	(10,083)
Foreign exchange gain (loss) on cash held in foreign currency	165	(187)
Change in cash and cash equivalents during the period	77	1,109
Cash and cash equivalents, beginning of period	626	1,448
Cash and cash equivalents, end of period	$ 703	$ 2,557

The notes are an integral part of these consolidated financial statements.

1. Reporting entity:

Arsenal Energy Inc. ("Arsenal" or the "Company") is an oil and gas exploration, development and production Company based in Calgary, Alberta, Canada. The Company conducts its operations in the Western Canadian Sedimentary basin and Williston basin in Canada and the United States. These condensed interim consolidated financial statements are comprised of the Company and its wholly owned subsidiaries, Arsenal Energy USA Ltd. and Arsenal Energy Holdings; which were incorporated in the USA and Canada respectively. Arsenal's principle place of business is located at Suite 1900, 639 – 5th Avenue SW, Calgary Alberta, Canada, T2P 0M9.

2. Basis of preparation:

(a) Statement of compliance:

These condensed interim consolidated financial statements have been prepared by management in accordance with International Financial Reporting Standards (IFRS) and International Accounting Standard (IAS) 34 *Interim Financial Reporting.* These condensed interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements and notes for the year ended December 31, 2011 and should be read in conjunction with the audited consolidated financial statements and notes for the year ended December 31, 2011. In the opinion of management, these condensed interim consolidated financial statements contain all adjustments necessary to present fairly Arsenal's financial position as at March 31, 2012 and the results of its operations and its cash flow for the three months then ended.

The condensed interim consolidated financial statements were authorized for issue by the Board of Directors on May 7, 2012.

(b) Basis of measurement:

The consolidated financial statements have been prepared on the historical cost basis except for the derivative financial instruments which are measured at fair value. The methods used to measure fair value are discussed in notes 3 and 10.

(c) Functional and presentation currency:

These consolidated financial statements are presented in Canadian dollars, which is the parent company's functional currency. Its subsidiary Arsenal Energy USA Ltd. has a U.S. dollar functional currency.

(d) Use of estimates and judgments:

The preparation of financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts regarding assets, liabilities, revenue, and expenses. Actual results may differ from estimated amounts as future confirming events occur.

Reserve estimates including production profiles, future development costs, and discount rates are a critical part of many of the estimated amounts and calculations contained in the financial statements. These estimates are verified by third party professional engineers, who work with information provided by the Company to establish reserve determinations. These determinations are updated at least on an annual basis.

Significant areas of estimation, uncertainty and critical judgments in applying accounting policies that have the most significant effect on the amount recognized in the consolidated financial statements include:

- Impairment testing – estimates of reserves, future commodity prices, future costs, production profiles, discount rates, market value of land.

2. Basis of preparation (continued):

- Depletion and depreciation - oil and natural gas reserves, including future prices, costs and reserve base to use on calculation of depletion.
- Decommissioning obligations – estimates relating to amounts, likelihood, timing, inflation and discount rates.
- Share-based compensation – forfeiture rates and volatility.
- Risk management contracts – expected future oil and natural gas prices and expected volatility in these prices.
- Deferred tax – estimates of reversal of temporary differences, tax rates substantively enacted, and likelihood of assets being realized.

3. Determination of fair values:

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

(i) Property, plant and equipment and exploration and evaluation assets:

The fair value of property, plant and equipment recognized in a business combination, is based on fair values. The fair value of property, plant and equipment is the estimated amount for which property, plant and equipment could be exchanged on the acquisition date between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The fair value of oil and natural gas interests (included in property, plant and equipment) and exploration and evaluation assets is estimated with reference to the discounted cash flows expected to be derived from oil and natural gas production based on externally prepared reserve reports. The risk-adjusted discount rate is specific to the asset with reference to general market conditions.

(ii) Cash and cash equivalents, accounts receivables, bank loans and accounts payables:

The fair value of cash and cash equivalents, accounts receivables, bank loans and accounts payable is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. At March 31, 2012 and December 31, 2011, the fair value of these balances approximated their carrying value due to their short term to maturity. Bank loans bear a floating rate of interest therefore carrying value approximates fair value.

(iii) Derivatives:

The fair value of forward contracts and swaps is determined by discounting the difference between the contracted prices and published forward price curves as at the statement of financial position date, using the remaining contracted oil and natural gas volumes and a risk-free interest rate (based on published government rates). The fair value of options and costless collars is based on option models that use published information with respect to volatility, prices and interest rates.

(iv) Stock options:

The fair value of employee stock options is measured using a Black Scholes option pricing model. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility (based on weighted average historic volatility adjusted for changes expected due to publicly available information), weighted average expected life of the instruments (based on historical experience and general option holder behavior), expected dividends and the risk-free interest rate (based on government bonds).

4. Exploration and evaluation assets:

Cost or deemed cost	Total
Balance at December 31, 2010	$ 6,394
Additions	9,364
Transfer to property, plant and equipment	(2,913)
Transfer to exploration and evaluation expenses	(3,745)
Balance at December 31, 2011	$ 9,100
Additions	1,011
Balance at March 31, 2012	$ 10,111

For the three months ended March 31, 2012, $45,725 (2011 - $732,048) of seismic costs were recorded directly to exploration and evaluation expense in the consolidated statement of loss.

5. Property, plant and equipment:

Cost or deemed cost	Total
Balance at December 31, 2010	$ 92,472
Additions	30,736
Transfer from exploration and evaluation assets	2,913
Property acquisition	38,575
Divestitures	(1,218)
Capitalized share-based compensation	297
Decommissioning obligations acquired and incurred	19,259
Change in decommissioning obligations	(1,216)
Change in translation of foreign operations	1,006
Balance at December 31, 2011	$ 182,824
Additions	6,361
Divestitures	(193)
Decommissioning obligations acquired and incurred	86
Capitalized share-based compensation	96
Changes in translation of foreign operations	(839)
Balance at March 31, 2012	$ 188,335

Accumulated Depreciation	Total
Balance at December 31, 2010	$ 18,141
Depletion and depreciation expense	13,117
Divestitures	(211)
Impairment	5,500
Change in translation of foreign operations	82
Balance at December 31, 2011	$ 36,629
Depletion and depreciation expense	5,985
Divestitures	(54)
Impairment	1,950
Changes in translation of foreign operations	(103)
Balance at March 31, 2012	$ 44,407

5. Property, plant and equipment (continued):

NBV	Total
Balance, December 31, 2011	$ 146,195
Balance, March 31, 2012	$ 143,928

The calculation of depletion for the three months ended March 31, 2012 included estimated future development and decommissioning costs of $136.1 million (March 31, 2011 - $36.9 million) associated with the Company's proved plus probable reserves and excludes salvage value of $10.5 million (March 31, 2011 - $6.1 million).

For the three months ended March 31, 2012, Arsenal capitalized general and administrative expenses of $514,000 (March 31, 2011 - $161,000) and $95,924 (March 31, 2011 - $89,999) of share based compensation.

During the three months ended March 31, 2012, the Company disposed of certain non-core properties for proceeds of $32,595 (December 31, 2011 - $472,591). This resulted in a gain of $870,364 (March 31, 2011 - nil).

6. Impairment loss:

As at March 31, 2012, as a result of depressed natural gas prices, the Company tested natural gas CGU's for impairment. The recoverable amount was determined using value in use, net of decommissioning obligations, based on discounted cash flows of proved plus probable reserves as estimated by the Company's third party reserve evaluators using forecast prices and costs and discount rates of between 15% and 20%.

During the three months ended March 31, 2012 it was determined that the net book value of certain CGU's exceeded the recoverable amount and an impairment of $1.95 million was recognized.

7. Bank loan:

At May 31, 2011, the Company's credit facility was reviewed, syndicated and increased from $40.0 million to $60.0 million based on the independent engineering report as at December 31, 2010. A review and update of the credit facility in November 2011, incorporated the $38.6 million property acquisition and drilling results since May 2011, and resulted in an increase in the credit facility to $75.0 million. The credit facility is available in Canadian and/or US dollar prime loans or in Bankers Acceptances and/or Libor borrowings. Interest on the Company's credit facility is at rates ranging from Canadian or US prime plus 1.00% to 2.50% on prime based loans and from the base rate plus 2.00% to 3.50% on Bankers Acceptances and on Libor based loans. The interest rate is set based on the Company's debt, as calculated for this purpose to include bank loan plus working capital (excess or deficiency), outstanding letters of credit and other miscellaneous items but excludes decommissioning obligations and risk management contracts (whether an asset or an obligation) to trailing funds flow ratio (funds flow for the last two quarters annualized) adjusted for interest and other financing expenses, expensed seismic expenditures, realized gains or losses on risk management contracts and any unusual or non-recurring items.

The credit facility has a revolving period of 364 days plus one year and is extendible annually. If not extended, the credit facility will automatically convert to a one year non-revolving term loan and all obligations under the credit facility shall be repaid or paid at the end of the one year period.

The credit facility is secured by an unlimited liability guarantee to the lenders, an ISDA Master Agreement, a demand debenture in the amount of $300,000,000 granting a first priority security interest over all present and after acquired personal property and a first floating charge over all

7. Bank loan (continued):

present and after acquired petroleum and natural gas interests and mortgages creating specific fixed charges on some of the oil and gas properties of the Company in North Dakota.

The credit facility is also subject to certain positive and negative covenants including a covenant not to dispose of assets or property having a fair aggregate value not exceeding 5% of the borrowing base with no adjustment to the borrowing base. In addition, the credit facility is subject to a semiannual borrowing base review based on internally generated engineering.

At March 31, 2012, debt under the credit facility amounted to $53,162,176 (December 31, 2011 – $52,062,272) and includes $5,000,000 (December 31, 2011 – $5,000,000) of US dollar denominated borrowings.

The Company's credit facility has a financial covenant that, without the written consent of the lender, would result in a breach of the agreement. The Company cannot permit:

- The adjusted working capital ratio (as defined in the agreement to include the unutilized portion of the facility and to exclude the value of any risk management contracts) to fall to below 1 : 1.

At March 31, 2012, the Company was in compliance with this covenant.

8. Decommissioning obligations:

	Three Months ended March 31, 2012	Year ended December 31, 2011
Decommissioning obligations, beginning of period	$37,326	$19,667
Obligations settled	(12)	(819)
Obligations acquired	-	18,703
Obligations disposed	(978)	(436)
Obligations incurred	86	622
Change in estimates	-	(1,214)
Foreign currency translation	(62)	94
Accretion expense	255	709
Decommissioning obligations, end of period	$36,615	$37,326

The Company's decommissioning obligations result from its ownership interest in oil and natural gas assets including well sites and gathering systems. The total decommissioning obligations are estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities and the estimated timing of the costs to be incurred in future years. The Company has estimated the net present value of the decommissioning obligations to be $36.6 million as at March 31, 2012 (December 31, 2011: $37.3 million) based on an undiscounted inflation adjusted total future liability of $51.4 million (December 31, 2011 - $52.4 million). These payments are expected to be made over the next 25 years with the majority of costs to be incurred between 2012 and 2022. The discount factor, being the risk free rate related to the liability, is 2.8% (December 31, 2011 2.8%).

9. Share capital:

At March 31, 2012, the Company was authorized to issue an unlimited number of common shares with the holders of common shares being entitled to one vote per share.

(a) Issued

	Three months ended March 31, 2012		Year ended December 31, 2011	
	Number of Shares	Share capital	Number of Shares	Share Capital
Balance, beginning of period	157,282	$136,860	140,812	$122,609
Issue of shares	-	-	22,159	21,051
Share issue costs	-	-	-	(1,695)
Transfer from contribute surplus on exercise of options	-	14	-	470
Issued on exercise of options	53	21	1,343	561
Repurchase of shares	(1,041)	(907)	(7,032)	(6,136)
Balance, end of period	156,294	$135,988	157,282	$136,860

Common shares

On February 15, 2011, the Company issued 22,158,500 common shares at $0.95 per share for gross proceeds of $21,050,575.

(b) Share based payments

The Company has a stock option plan in which the Company may grant options to its directors, officers, employees and consultants for up to 10% of its outstanding common shares. Under the plan, the exercise price of each option granted shall not be less than the market price of the Company's common shares on the date the option is granted and the contractual term of each option is not to exceed five years. All options vest over a period as determined by the Board of Directors. Stock options are granted periodically throughout the year.

The following table summarizes the status of the Company's stock option plan as follows:

	Number of options	Weighted average exercise price
Balance, December 31, 2010	12,755	$ 0.62
Granted	4,840	0.68
Exercised	(1,343)	0.42
Expirations	(390)	1.09
Forfeited	(1,168)	0.72
Balance, December 31, 2011	14,694	$ 0.64
Granted	250	0.67
Exercised	(53)	0.39
Forfeited	(404)	0.72
Balance, March 31, 2012	14,487	$ 0.64

9. Share capital (continued):

The following table summarizes information about the stock options outstanding and exercisable at March 31, 2012:

	Options outstanding			Options exercisable	
Range of exercise prices	Number of options	Weighted average exercise price	Weighted average remaining life (years)	Number of options	Weighted average exercise price
$0.20 to $0.35	1,278	$0.21	1.75	1,278	$0.21
$0.36 to $0.50	2,543	0.40	1.84	2,208	0.40
$0.51 to $0.70	4,876	0.63	3.52	1,086	0.61
$0.71 to $1.00	5,790	0.86	3.06	2,460	0.85
Total	14,487	$0.64	2.89	7,032	$0.55

Options granted to employees are accounted for using the fair value method. The fair value of stock options was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three months ended March 31, 2012	Year ended December 31, 2011
Risk free interest rate	1.15 – 1.51%	1.18 – 2.25%
Expected life	4 years	4 years
Expected volatility	83 - 85%	87 - 92%
Expected dividend	nil	nil
Expected forfeitures	5%	5%
Weighted average fair value per share	$0.41	$0.44

(c) Loss per share

The following table shows the weighted average number of common and diluted shares.

	Three months ended March 31, 2012	Three months ended March 31, 2011
Basic and diluted:		
Loss per share basic and diluted	$(0.03)	$(0.05)
Weighted average shares outstanding:		
Basic and Diluted	156,648	151,904

In computing diluted loss per share for the three months ended March 31, 2012, 14,487,003 (2011- 12,203,500) options were excluded from the dilution calculations as they were anti-dilutive.

(d) Normal course issuer bid:

On June 16, 2011, the Company announced its intention to make a normal course issuer bid ("NCIB") that commenced June 20, 2011 and ends June 19, 2012. A total of 8,128,724 common shares may be acquired under the bid representing 5% of the common shares outstanding as of June 14, 2011. To December 31, 2011, the Company had purchased 5,458,544 common shares at a cost of $3,519,673 or $0.65 per share plus expenses. The stated value of these shares

9. Share capital (continued):

exceeded the cost by $1,243,622 and has been recorded to contributed surplus. For the three months ended March 31, 2012, the Company had purchased 1,041,500 common shares at a cost of $712,780 or $0.68 per share plus expenses. The stated value of these shares exceeded the cost by $194,002 and has been recorded to contributed surplus.

10. Risk management and financial instruments:

The Company's activities expose it to a variety of financial risks that arise as a result of its exploration, development, production, and financing activities such as:

- market risk;
- credit risk; and
- liquidity risk; and

This note presents information about the Company's exposure to each of the above risks, the Company's objectives, policies and processes for measuring and managing risk, and the Company's management of capital. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors oversees managements' establishment and execution of the Company's risk management framework. Management has implemented and monitors compliance with risk management policies. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. There has been no change in the Company's approach to these activities from those disclosed in the Company's annual financial statements for the year ended December 31, 2011.

a) Market Risk:

Foreign currency exchange rate risk

Foreign currency exchange rate risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in foreign exchange rates. Canadian commodity prices are influenced by fluctuations in the Canadian to U.S. dollar exchange rate. As at March 31, 2012, the Company does not have any foreign currency exchange contracts in place.

Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank loan which bears a floating rate of interest. Average bank debt outstanding during the three months ended March 31, 2012 was $54.8 million (2011 $5.7 million). For the three months ended March 31, 2012, a 1.0 percent change to the effective interest rate would have a $136,000 impact on net loss (2011 - $14,000).

During the quarter, the Company has attempted to mitigate the impact of future fluctuations in interest rates on its outstanding debt by entering into a swap contract fixing the base interest rate on $20 million of banker's acceptance borrowings as outlined below. These rates are, under the Company's credit facility, subject to additional stamping fees from 2.00% to 3.50% depending on the debt to cash flow ratio, as defined, and as calculated at the Company's most recent quarter end.

($Cdn.)

Subject of Contract	Remaining Term	Notional Quantity	Reference	Strike Price	Fair value
30 day BA rate	April 1, 2012 - Feb 13, 2015	$20,000	CAD-BA-CDOR	1.50%	$(51)

10. Risk management and financial instruments (continued):

Commodity price risk

Commodity price risk is the risk that future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by the relationship between the Canadian and United States dollar as well as global economic events that dictate the levels of supply and demand. The Company has attempted to mitigate a portion of the commodity price risk through the use of commodity price contracts.

As at March 31, 2012, the Company had four crude oil swaps in-place fixing the price of future production for a specific period of time. All risk management contracts are denominated in Canadian dollars. For the three months ended March 31, 2012, the Company recorded a realized commodity contract loss of $781,582 (March 31, 2011 - $271,011 loss) and an unrealized commodity contract loss of $2,501,296 (March 31, 2011 - $2,941,343 loss).

The following table details the mark-to–market risk management contract presentation in the financial statements at the dates indicated:

	As at March 31, 2012	As at March 31, 2011
Total fair value consists of the following:		
Fair value, end of period - current portion	$ (3,785)	$ (2,105)
Fair value, end of period - long-term portion	$ (2,492)	$ (2,257)
Total fair value, end of period	$ (6,277)	$ (4,362)

The following table reconciles the changes in the fair value of risk management contracts outstanding at the dates indicated:

	Three months ended March 31	
	2012	2011
Fair value, beginning of period	$ (3,776)	$ (1,421)
Changes in fair value	(3,283)	(3,212)
Settlement paid (received)	782	271
Fair value, end of period	$ (6,277)	$ (4,362)

The Company had the following risk management contracts outstanding as at March 31, 2012.

($Cdn.)

Commodity Sold	Volume Sold	Remaining Term	Cdn $ Pricing	Fair Value
Oil	300 bbl per day	April 1, 2012 - Dec 31, 2013	$92.10 per bbl	$ (2,349)
Oil	400 bbl per day	April1, 2012 - Dec 31, 2013	$92.10 per bbl	(3,131)
Oil	300 bbl per day	April 1, 2012 - Dec 31, 2012	$100.00 per bbl	(366)
Oil	300 bbl per day	January 1, 2013 - Dec 31, 2013	$101.00 per bbl	(431)
				$ (6,277)

Commodity price sensitivity:

Commodity Price		
Oil production sold under risk management contract (barrels)		640,000
Price Change (per bbl)	$	1.00
Sensitivity - loss before income tax	$	640

10. Risk management and financial instruments (continued):

b) Fair value of financial instruments:

The Company's exposure under its financial instruments is limited to financial assets and liabilities, all of which are included in these financial statements. Financial instruments include cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, risk management contracts and bank debt. The fair values of financial assets and liabilities that are included in the balance sheet approximate their carrying amounts. Certain of these financial instruments including risk management contracts are measured in the financial statements at fair value. These financial instruments require disclosure about how fair value was determined based on significant levels of inputs described in the following hierarchy:

• Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and value to provide pricing information on an ongoing basis.

• Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date. Level 2

valuations are based on inputs including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.

• Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

The fair value of risk management contracts as presented on the balance sheet is determined by discounting the difference between the contracted price and published forward price curves as at the balance sheet date, using the remaining contracted oil and natural gas volumes and are considered Level 2.

c) Credit risk:

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meets its contractual obligations, and arises principally from the Company's receivables from joint interest partners and petroleum and natural gas marketers. The maximum exposure to credit risk at year end is as follows:

	March 31, 2012	December 31, 2011
Accounts receivable	$8,989	$11,677

A substantial portion of the Company's accounts receivable are with customers and joint interest partners in the oil and gas industry and are subject to normal market and industry credit risks.

As at March 31, 2012 the Company's receivables consisted of $3,105,409 (December 31 2011 - $3,105,667) from joint interest partners the majority of which has either been collected or is expected to be collected within the next 60 days, $5,771,004 (December 31, 2011 - $8,057,059) of receivables from petroleum and natural gas marketers, which have been collected and $112,870 (December 31, 2011 - $514,721) of other receivables. At December 31, 2011, Arsenal had approximately $712,752 (December 31, 2011 - $757,492) of receivables that are considered past due and collection efforts, including the taking of production and consideration of legal action have commenced.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated

10. Risk management and financial instruments (continued):

with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint interest receivables are typically collected within one to three months of the joint interest bill being issued to the partner. The Company attempts to mitigate the risk from joint interest receivables by obtaining partner approval of significant capital expenditures and payment of cash advances prior to expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances are dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition further risk exists with joint interest partners as disagreements occasionally arise that increase the potential for non-collection. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint interest partners; however the Company does have the ability to request deposits and to withhold production from joint interest partners in the event of non-payment.

d) Liquidity risk:

Liquidity risk is the risk that the Company will encounter difficulty in meeting obligations associated with the financial liabilities. The Company's financial liabilities consist of accounts payable, financial instruments and the bank loan. Accounts payable consists of invoices payable to trade suppliers for office, field operating activities and capital expenditures. The Company processes invoices within a normal payment period. The Company maintains a revolving credit facility, as outlined in note 7, that is subject to renewal annually by the lenders. The Company also maintains and monitors a certain level of cash flow which is used to partially finance all operating and capital expenditures as the Company does not pay dividends.

11. Capital management:

In order to continue the Company's ongoing exploration and development program, the Company must maintain a strong capital base. A strong capital base results in increased market confidence, an essential factor in maintaining existing shareholders and in attracting new investors. The Company is committed to establishing and maintaining a strong capital base to ensure the Company has access to the equity and debt markets when deemed advisable. In order to maintain a strong capital base, the Company continually monitors the risk reward profile of its exploration and development projects and the economic indicators in the market including commodity prices, interest rates and foreign exchange rates. It then determines increases or decreases to its capital budget and what, if any, additional initiatives may need to be implemented.

The Company considers shareholder's equity, bank loan and working capital (excess or deficiency) as components of its capital base. The Company can access or increase its capital base through the issuance of shares and through bank borrowings that are based on reserves. The Company can safeguard its capital base by stabilizing its funds from operations, by fixing, or reviewing the advisability of fixing, interest rates and commodity prices on all or a portion of the Company's debt and production, by closely monitoring expenses and by closely monitoring and scrutinizing the results of its capital expenditure program and adjusting capital expenditures as required based on economic conditions and drilling results.

The Company monitors its capital base based primarily on its debt to annualized funds flow ratio and its debt to equity ratio. Debt includes bank borrowings, plus or minus working capital and excludes decommissioning obligations and risk management contracts (whether an asset or an obligation). Annualized funds flow (a non-GAAP measure) is calculated as cash flow from operations before changes in non-cash working capital, decommissioning obligations settled and exploration and evaluation expenses from the Company's most recent quarter multiplied by four adjusted, if required, by increasing or decreasing commodity price expectations, future production profiles, the Company's risk management position and other non-recurring items. The Company's goal is to target this ratio at 1 : 1.5 but the ratio can and will fluctuate based on the timing of

11. Capital management (continued):

property transactions, commodity prices and on the mix of exploratory and development drilling. During periods of extreme commodity price declines, high drilling activity or after large property or corporate acquisitions, it is expected that the ratio would increase and during periods of high commodity prices and low activity levels, it is expected that the ratio would decrease. The Company's focus in these instances is to concentrate on bringing the ratio back into the target range. The ratio represents the time period it would take to pay off the debt if no further capital expenditures were incurred and if funds from operations remained constant. The Company prepares an annual operating and capital expenditure budget. The budget is updated when critical factors change and when actual results are realized and compared to budget. Critical factors include economic factors such as the state of equity markets, changes to commodity prices, interest rates and foreign exchange rates and non economic factors such as drilling results and production profiles. The Company's board of directors approves the budget and reviews changes thereto. The Company has targeted a debt to equity ratio of 0.5 : 1. This ratio will also fluctuate over time depending on the state of equity markets and the results of operations.

At March 31, 2012, the Company's net debt to annualized funds flow (Q1 cash flow adjusted for significant and non-recurring realized commodity gains or losses and seismic expenditures expensed) ratio was 2.08 : 1 and its debt to equity ratio was 1.14 : 1. The property acquisition of $38.6 million in November 2011 increased debt thereby increasing the debt to annualized funds flow ratio. At March 31, 2012, both the net debt to annualized funds flow ratio and the debt to equity ratio, while higher than the targeted ratios, are within an acceptable target range as established in management's strategic goals and guidelines. Key factors that will determine if the Company will be able to remain within its established guidelines are production rates from drilling, commodity (particularly crude) prices, interest and foreign exchange rates and the magnitude and timing of the Company's capital expenditure program.

The Company's share capital is not subject to external restrictions, however the credit facilities are petroleum and natural gas reserves based. The Company has not paid or declared any dividends since the date of incorporation and does not anticipate doing so in the foreseeable future.

There were no changes in the Company's approach to capital management during the period.

Net debt	March 31, 2012	March 31, 2011
Cash and cash equivalents	$ 703	$ 2,557
Accounts receivable, prepaids and inventory	10,095	9,521
Accounts payable and accrued liabilities	(14,342)	(18,549)
Working capital deficiency	$ (3,544)	$ (6,471)
Bank loan	(53,162)	(400)
Net debt	$ (56,706)	$ (6,871)
Annualized funds flow [1,2]	$ 27,198	$ 20,423
Net debt to annualized funds flow ratio	2.08	0.34
Shareholders' equity	$ 49,659	$ 52,722
Debt to equity	1.14	0.13

[1] Excludes significant realized gains and losses on commodity contracts and seismic expenses
[2] Based on the last quarter's annualized funds flow

12. Supplemental cash flow information:

Three months ended March 31	2012	2011
Change in non-cash working capital items:		
Accounts receivable	$ 2,688	$ (1,053)
Prepaid expenses and deposits	376	30
Inventory	6	-
Accounts payable and accrued liabilities	(3,111)	1,229
	(41)	206
Amounts relating to operating activities	2,172	(1,466)
Amounts relating to financing activities	57	77
Amounts relating to investing activities	(2,270)	1,595
	(41)	206
Taxes Paid	-	-
Interest paid	$ 468	$ 72

13. Finance expenses:

Three months ended March 31		
	2012	2011
Accretion of decommissioning obligation	$ 255	$ 172
Interest and other financing fees	528	127
	$ 783	$ 299

14. Segmented information:

A portion of the Company's assets and revenues are earned in the United States and Canada, and are monitored as an identifiable reporting segment by management. Business risks and economic indicators are similar across all geographical regions.

March 31, 2012 (000's $Cdn.)	Canada	U.S.	Total
Oil and gas revenue	13,644	7,555	21,199
Income (loss) before income taxes	(6,271)	2,768	(3,503)
Operating income[1]	4,659	4,412	9,071
Exploration and evaluation assets	10,111	-	10,111
Property, plant and equipment	103,688	40,240	143,928
Capital expenditures	1,428	4,933	6,361
Exploration and evaluation expenditures	1,011	-	1,011
Property dispositions	(33)	-	(33)

March 31, 2011 (000's $Cdn.)	Canada	U.S.	Total
Oil and gas revenue	7,472	4,147	11,619
Income (loss) before income taxes	(8,034)	(157)	(8,191)
Operating income[1]	4,044	2,477	6,521
Exploration and evaluation assets	4,666	-	4,666
Property, plant and equipment	54,986	23,576	78,562
Capital expenditures	1,128	6,156	7,284
Exploration and evaluation expenditures	4,867	-	4,867
Property dispositions	(473)	-	(473)

[1] Defined as oil and gas revenues less royalties, operating costs and transportation

15. Commitments and contingencies:

a) Office premises, equipment leases and firm service transportation:

The Company leases its office premises, computer equipment and field vehicles through an operating lease for accounting purposes. As a result of the property acquisition in 2011 the Company assumed a firm service transportation commitment for its gas production in Desan.

The estimated operating lease commitments and firm service transportation commitments are as follows:

2012	$ 874
2013	1,007
2014	919
2015	877
2016	828
Thereafter	398
Total commitment	$ 4,903

b) Outstanding lawsuits:

Various lawsuits have been filed against the Company for incidents which arose in the ordinary course of business. In the opinion of management, the outcome of the lawsuits, now pending, is not determinable or not material to the Company's operation. Should any loss result from the resolution of these claims, such loss will be charged to operations in the year of resolution.